

NPS-AM-09-029



EXCERPT FROM THE PROCEEDINGS

OF THE SIXTH ANNUAL ACQUISITION RESEARCH SYMPOSIUM

INCENTIVE ARRANGEMENTS FOR SPACE ACQUISITIONS

Published: 22 April 2009

by

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**6th Annual Acquisition Research Symposium
of the Naval Postgraduate School:**

**Volume II:
Defense Acquisition in Transition**

May 13-14, 2009

Approved for public release, distribution is unlimited.

Prepared for: Naval Postgraduate School, Monterey, California 93943



ACQUISITION RESEARCH PROGRAM
GRADUATE SCHOOL OF BUSINESS & PUBLIC POLICY
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Report Documentation Page			Form Approved OMB No. 0704-0188		
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1. REPORT DATE APR 2009		2. REPORT TYPE		3. DATES COVERED 00-00-2009 to 00-00-2009	
4. TITLE AND SUBTITLE Incentive Arrangements for Space Acquisitions			5a. CONTRACT NUMBER		
			5b. GRANT NUMBER		
			5c. PROGRAM ELEMENT NUMBER		
6. AUTHOR(S)			5d. PROJECT NUMBER		
			5e. TASK NUMBER		
			5f. WORK UNIT NUMBER		
7. PERFORMING ORGANIZATION NAME(S) AND ADDRESS(ES) Naval Postgraduate School, Monterey, CA, 93943			8. PERFORMING ORGANIZATION REPORT NUMBER		
9. SPONSORING/MONITORING AGENCY NAME(S) AND ADDRESS(ES)			10. SPONSOR/MONITOR'S ACRONYM(S)		
			11. SPONSOR/MONITOR'S REPORT NUMBER(S)		
12. DISTRIBUTION/AVAILABILITY STATEMENT Approved for public release; distribution unlimited					
13. SUPPLEMENTARY NOTES					
14. ABSTRACT					
15. SUBJECT TERMS					
16. SECURITY CLASSIFICATION OF:			17. LIMITATION OF ABSTRACT Same as Report (SAR)	18. NUMBER OF PAGES 38	19a. NAME OF RESPONSIBLE PERSON
a. REPORT unclassified	b. ABSTRACT unclassified	c. THIS PAGE unclassified			

The research presented at the symposium was supported by the Acquisition Chair of the Graduate School of Business & Public Policy at the Naval Postgraduate School.

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Incentive Arrangements for Space Acquisitions

Presenter: James Gill

Executive Summary

Disclaimer: The views represented in this report are those of the author and do not reflect the official policy position of the US Air Force, the Department of Defense, or the Federal Government.

Space Systems acquisition has experienced a paradigm shift in its approach toward the use of contract incentives. This shift in the use of incentives is a matter of tremendous importance to those who develop and buy major Space Systems, but, more importantly, to the industry partners that deal with the Space & Missile Systems Center. This shift began under the Bush Administration and, based upon initial signs, may accelerate under the Obama Administration.

What are some of these changes, and what will be the impact of revising the government's business strategy? In order to get some perspective on the reasons for the changes, it is necessary to understand the history of the use of incentives in the acquisition of major systems by the DoD.

How does the DoD incentivize contractors to perform this important job? What do they use to motivate performance, and how do they monitor that performance to ensure that this fee is truly earned?

In the acquisition business, we face these questions on almost a daily basis. We get them from the media. We get them from the Congress. We get them from the senior leadership within the Executive Branch, right up to and including the President of the United States.

Why can't we get answers to these questions? To some degree, it is because incentives are a part of human nature, and their effectiveness is somewhat relative. We use them in daily life to varying degrees of success. Would your son or daughter do their homework every night if you provided no incentive? What form of incentive works more effectively: positive or negative? How do we know? Some would work, some would not. It seems intuitive that people respond to stimuli, both in positive and negative forms.

If that is the case, then why is there even a question as to whether incentives motivate performance? Perhaps the more important question goes to the effectiveness of the incentive applied. If we read the GAO Report entitled *DOD Has Paid Billions in Award and Incentive Fees Regardless of Acquisition Outcomes* (2005, December), the GAO does not believe the Department of Defense uses incentive arrangements very effectively.

The discussion must depend upon the definition of effectiveness. There is a difference as to the relative importance of cost, schedule and technical elements of



incentive arrangements to those assessing the performance of the Program Offices that are responsible for the acquisition of these systems. Program Managers have tended to view technical performance and mission success as the more important criteria, while Congress looks at cost and schedule for validation on a program's success or failure. On the other hand, the user wants it when he needs it and wants it to work.

The beauty of the DoD acquisition process is both in its simplicity and its complexity. The President has articulated his vision of the federal contracting process and has stated his goals, which are consistent with the regulatory directions found in the *Federal Acquisition Regulation*. There should be a preference for fixed-price contracts; cost overruns are never a good thing, and profit should be tied in some manner to successful outcomes.

The simplicity of those thoughts articulated in his Executive Order (2009) becomes complicated in their application to major defense programs—especially major space systems development, which has enormous complexity and technical challenges. Many of these systems require pushing the state-of-the-art well beyond previous capabilities and into areas that have not been attempted in the past.

Why has this issue become so important? To some extent, it has always been a matter of pressing urgency, but recent economic circumstances have made our ability to get more “bang for the buck” a national emergency. One way to add to the capabilities of the warfighters, while reducing the dollars required supporting them, is to more effectively manage the money expended in the procurement of major systems. This may be accomplished through a more effective use of incentive techniques.

The GAO Report (2005, December) focused attention on the problems that the DoD has had in using award and incentive fees in the development and production of major systems. It was highly critical of the use of award and incentive arrangements and recommended a number of changes to the use of award-fee contracts.

This Report was followed by a number of policy directives issued from the OSD, the Secretary of the Air Force, Major Air Force Commands and respective Buying Organizations and Program Offices. This article will focus on the impact that the GAO 2005 Report has had on the way that the Air Force, and most specifically, the Space & Missile Systems Center, has addressed contracting concerns.

After receiving direction to implement several of the recommendations of the GAO Report from AT&L and SAF, the PEO for Space (General Hamel) issued a policy directive implementing a series of changes and mandating the development of an Incentives Guide. A follow-on initiative by the SMC Commander was that a course on incentives would be created to train the SMC workforce on the theory of Incentive Contracting.

In the Air Force, there had been a preference for the use of award-fee contracts for a period of 15-20 years. Acquisition Plans would not be approved without the use of award fee as the primary incentive arrangement. This dependency upon award fee was



predicated upon two basic theories: first, that fee has a significant ability to influence performance on the part of a contractor, and second, that award fee can be used to leverage performance immediately. The decision of the Fee Determining Official was not initially deemed to be subject to the “Disputes” remedies, so it gave significant leverage to the Program Manager, as Fee Determining Official, over the behavior and performance of the contractor.

Why was this so important? Well, in conjunction with the normal budgetary turbulence associated with the acquisition of a program worth billions of dollars, the era of acquisition reform had turned over responsibility for development to the contractors, often through the use of an approach known as Total System Performance (or Program) Responsibility (TSPR). TSPR was a natural outgrowth of several factors, not the least of which was the “Peace Dividend” and the resultant reduction in the DoD workforce. In order to save dollars, the concept of TSPR allowed the government to eliminate many of the positions that were linked to the “Oversight” of contractor performance. It also eliminated the need for many of the “overly demanding” specifications and standards that industry had suggested for many years were not necessary and were overly burdensome.

The concept of “Insight not Oversight” was a mantra that was repeated almost as a solution to all of the problems that were associated with the development of major DoD systems. Unfortunately, it became apparent that without this oversight, many of the processes that had contributed to the technical successes were no longer utilized. The initial reports on systems such as SBIRS were overly optimistic and did not recognize the problems that were being experienced until hundreds of millions of overrun dollars had been incurred.

The incentive structure (award fee) was designed to give the government the opportunity to monitor performance and to provide direction, especially to those programs experiencing cost, schedule and technical problems. The Award Fee Review Board would evaluate performance against the Award Fee Plan and distribute each award fee based upon the contractor’s performance. The GAO Report (2005, December) indicated that this approach did not always result in successful acquisition outcomes as anticipated.

Accordingly, under a “Back to the Basics” approach, there has been a move away from the CPAF paradigm. The shift in approach has taken SMC to a slightly different strategy. There is now an emphasis upon ensuring successful outcomes though the use of more mission-success initiatives and of more objective criteria both in CPIF arrangements and when appropriate, within the Award Fee itself.

To facilitate this shift, the Incentive Guide was published March 2007, and the first Incentives course was held in November 2008. The basics of incentive contracting has not changed; the emphasis on utilizing the correct strategy for each acquisition is now a mandatory requirement for all Acquisition Strategy Plans. Leadership now requires a cogent use of a number of incentive techniques when managers are



formulating the strategy for the development of major systems. File documentation reflects the degree of analysis that was used in formulating the incentives approach.

So what is the change? The change will most likely be one of emphasis. This emphasis has manifested itself in several ways, the first of which highlights the nature of the relationship between the government and the contractor. Since the onset of the Acquisition Reform period, the concept of teaming has been the norm. The Integrated Program Team demonstrates the concept as a practice, with the members of the team working toward a common end: delivery of the system.

The focus on Incentive arrangements is now one of accountability and outcome-based arrangements. How will this translate into contract language? It is likely there will be a shift in the payment of incentives; they may become more back-loaded, giving the government the opportunity to see what the outcome will be prior to payment of much of the fee. A second possibility would be a form of payback in which fee already paid will be tied to the eventual successful demonstration of the program. This approach has been used in the past, most notably by NASA to varying degrees of success. It does cause some accounting issues for contractors in the manner in which they are able to book profit.

Other areas that are under consideration include the use of negative incentives. These may be used to offset positive incentives such as on-orbit satellite incentives. We have used these in the past, and the results have been mixed. Most of the satellite systems have exceeded their life expectancy, but that begs the question as to how reasonable were the initial requirements against which the incentives were based?

The most apparent consequence of the shift in policy is that there will be some difficulty in getting approval for the use of CPAF-type arrangements with subjective criteria. This, in itself, is not a bad thing. It is reasonable to challenge any approach that does not use a firm-fixed-price type of contract. The *FAR* requires it. In the arena of major space systems, there can be a broad spectrum of contract types and incentives that should be considered before deciding upon a specific type.

These include the cost-plus-award-fee type of contract. It may certainly be reasonable to advocate this type of arrangement for the development of high-risk/ high-reward type of programs. The supporting rationale should stand up to close scrutiny by reviewing bodies. In some cases, we have been able to find more objective criteria that can be used to show that performance has been accomplished; such data contribute to supporting the desire for outcome-based incentive expectations.

There has also been a shift in the approach to the development process in two ways: first, a return to the basics—including a more vibrant systems engineering process, a more diligent cost-estimating approach and more oversight on the contractor. In conjunction with these changes, we will be tying the earning of fee to cost, schedule and performance criteria, in part through a more robust earned value system. One fault in the acquisition reform process is the lack of visibility into performance that had been available to the government through the Cost Schedule Control System Criteria



(CSCSC) prior to the reform period. Earned Value is a high-emphasis program for tracking contractor performance, and incentives may be tied more closely to this system in the future. The caveat to this approach is the potential for gaming by the contractor, a fix for which could be the payback mentioned earlier.

Another initiative that has been implemented is the use of Block upgrades. This is a form of evolutionary acquisition in which higher-risk technology is not incorporated into the system until it has been demonstrated through the use of risk-reduction efforts phased into the system in later iterations. This may impact incentives, as it should reduce the program risk from a technical standpoint and allow for better cost and schedule predictability. This reduced risk should allow for a high confidence in predicting contract parameters and may allow for different incentive structures.

So what else lies ahead for contract incentives? It seems likely that more accountability will be incorporated into new incentive arrangements. There will be some pressure to use more fixed-price arrangements. The use of negative incentives will be more prevalent. Consistent with recent legislation, there will be a push to define what constitutes minimum performance against which no fee will be earned. If award fee is used, objective criteria should be developed. Performance-based work statements should help define the criteria against which fee may be evaluated and paid.

This brings about a question as to incentives for a service-type activity. There has been a great deal written concerning the appropriate use of incentives (most notably contract type) for major systems. There has been less written with regard to the use of incentives for service-type effort. Space systems have historically been oriented toward supply type of deliverable end-items. We launched space vehicles that were delivered as hardware (Atlas, Titan, and Delta) and accepted delivery of these rockets. Now, we are launching via service-type contracts, buying a delivery of a satellite into an orbit.

As the DoD shifts from supplies to services, it becomes even more important to define incentives for these services. We have found that future business opportunities are at least as important as fee to these types of arrangements.

But the key question is how will the new Administration put its stamp on the incentives process? As the new leadership assumes its role, we are certain to find out more, but it is safe to bet that there will be some change in the near future. The fundamental philosophy will remain the same: a quality product, delivered on time, for a reasonable profit. The devil will be in the details.

List of References

Obama, B. (2009, March 4). *Government contracting*. Memorandum for the Heads of Executive Departments and Agencies. Washington, DC: White House.

GAO. (2005, December). *DOD has paid billions in award and incentive fees regardless of acquisition outcomes* (GAO-06-66). Washington, DC: Author.



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- Acquiring Combat Capability via Public-Private Partnerships (PPPs)
- BCA: Contractor vs. Organic Growth
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- Managing Services Supply Chain
- MOSA Contracting Implications
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- Private Military Sector
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- Spiral Development
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- The Software, Hardware Asset Reuse Enterprise (SHARE) repository

Contract Management

- Commodity Sourcing Strategies
- Contracting Government Procurement Functions
- Contractors in 21st Century Combat Zone
- Joint Contingency Contracting
- Model for Optimizing Contingency Contracting Planning and Execution
- Navy Contract Writing Guide
- Past Performance in Source Selection
- Strategic Contingency Contracting
- Transforming DoD Contract Closeout
- USAF Energy Savings Performance Contracts
- USAF IT Commodity Council
- USMC Contingency Contracting

Financial Management

- Acquisitions via leasing: MPS case
- Budget Scoring
- Budgeting for Capabilities-based Planning
- Capital Budgeting for DoD



- Energy Saving Contracts/DoD Mobile Assets
- Financing DoD Budget via PPPs
- Lessons from Private Sector Capital Budgeting for DoD Acquisition Budgeting Reform
- PPPs and Government Financing
- ROI of Information Warfare Systems
- Special Termination Liability in MDAPs
- Strategic Sourcing
- Transaction Cost Economics (TCE) to Improve Cost Estimates

Human Resources

- Indefinite Reenlistment
- Individual Augmentation
- Learning Management Systems
- Moral Conduct Waivers and First-term Attrition
- Retention
- The Navy's Selective Reenlistment Bonus (SRB) Management System
- Tuition Assistance

Logistics Management

- Analysis of LAV Depot Maintenance
- Army LOG MOD
- ASDS Product Support Analysis
- Cold-chain Logistics
- Contractors Supporting Military Operations
- Diffusion/Variability on Vendor Performance Evaluation
- Evolutionary Acquisition
- Lean Six Sigma to Reduce Costs and Improve Readiness
- Naval Aviation Maintenance and Process Improvement (2)
- Optimizing CIWS Lifecycle Support (LCS)
- Outsourcing the Pearl Harbor MK-48 Intermediate Maintenance Activity
- Pallet Management System
- PBL (4)
- Privatization-NOSL/NAWCI
- RFID (6)
- Risk Analysis for Performance-based Logistics
- R-TOC Aegis Microwave Power Tubes



- Sense-and-Respond Logistics Network
- Strategic Sourcing

Program Management

- Building Collaborative Capacity
- Business Process Reengineering (BPR) for LCS Mission Module Acquisition
- Collaborative IT Tools Leveraging Competence
- Contractor vs. Organic Support
- Knowledge, Responsibilities and Decision Rights in MDAPs
- KVA Applied to Aegis and SSDS
- Managing the Service Supply Chain
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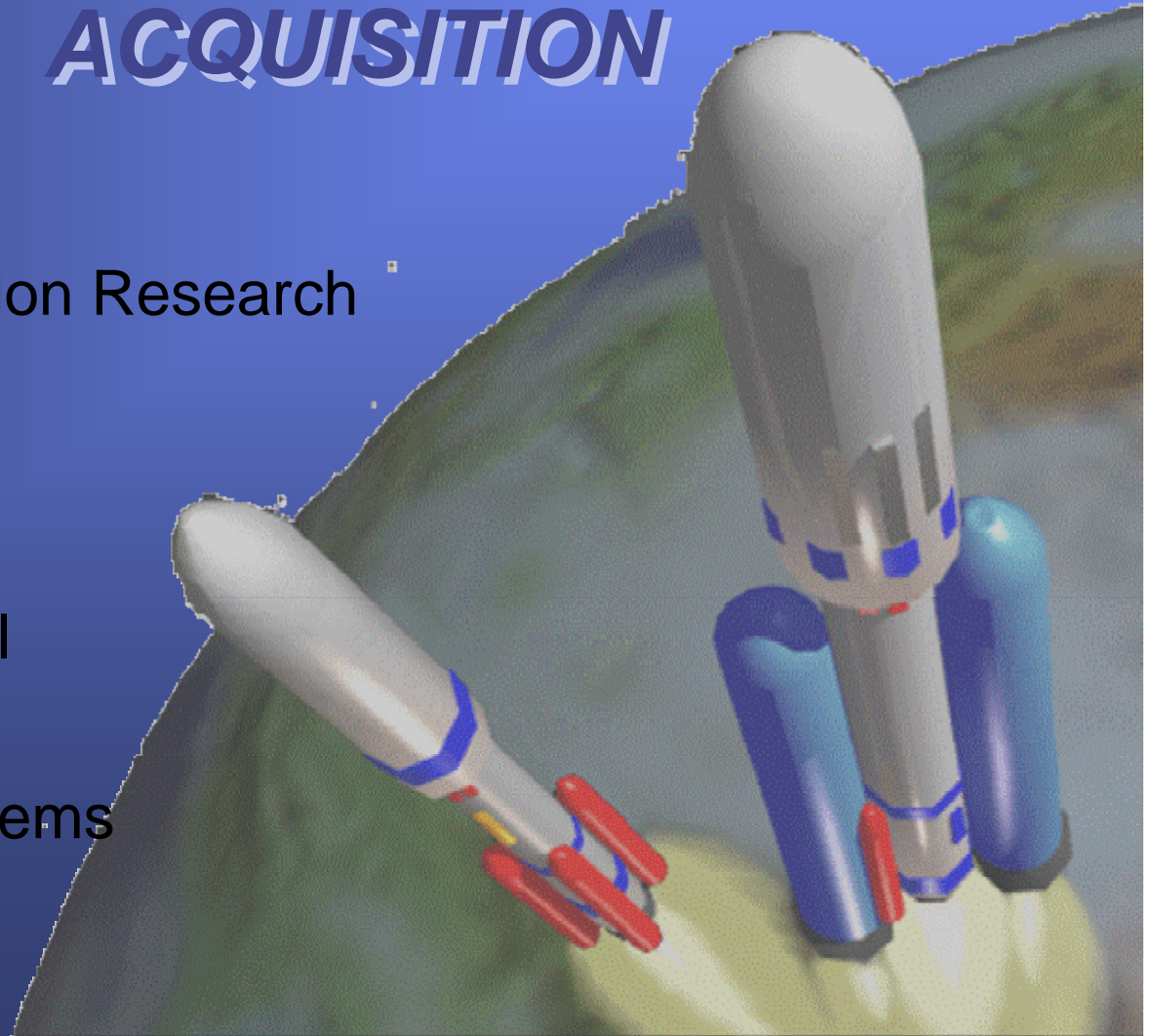
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INCENTIVE ARRANGEMENTS FOR SPACE ACQUISITION

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Symposium

Presenter: James Gill
Technical Advisor
Space & Missile Systems
Center





OUTLINE

- ▶ **Historical Use of Incentives at SMC**
- ▶ **Incentive Reform**
- ▶ **Current Initiatives**
- ▶ **Way Ahead**





WHAT ARE INCENTIVES?

► GAO defines Incentive Contracts as:

- **“A contract used to motivate a contractor to provide supplies or services at lower costs and in certain instances, with improved delivery or technical performance, by relating the amount of fee to contractor performance”***

► Incentives, for the purpose of this briefing, may be defined as the approach by which the customer motivates performance by the use of positive and negative provisions to a Kt for a product or service

* GAO Report 06-66, *DOD's use of Monetary Incentives*





DO INCENTIVES WORK?

- ▶ **Fundamental Question – Still Being Debated**
- ▶ **GAO Suggests that there is no evidence that Incentives alter behavior**
- ▶ **Most Contractors want to do good work – Do Incentives help set priorities?**
- ▶ **Incentives are Situational**
 - **Motivational prioritization is critical**
- ▶ **All Contractors Consider Fee when evaluating Business Opportunities, some cases fee not primary concern**
 - **If not Fee, then what?**



DO INCENTIVES WORK?

- ▶ **How Can the Government Make Performance a Condition of Receiving Fee? Should It?**
- ▶ **How about payback – a good idea?**
- ▶ **For Service Effort, What Incentive Arrangements Motivate Performance?**
 - **PBSOW's tied to fee?**
 - **Where and How Much?**
- ▶ **Especially in today's harsh economic times – future Business is High on contractor's list of importance**



HISTORICAL USE OF INCENTIVES AT SMC?

- ▶ **1970's - 80's Incentives included CPIF R&D contracts, orbital incentives, cost incentives, warrantees, EPA's DTUPC, VECF**
 - **Adversarial relationship with Industry**
- ▶ **80's - 90's Druyun Era rise of the use of Award Fee, Fixed-Price development contracts, (rise and fall)**
- ▶ **90's - 00's Era of Acquisition Reform – TSPR, commerciality, Lightning Bolts, Insight, IPT's**
 - **Non-adversary relationship (teammates)**
- ▶ **'05 - present – Back to Basics, verify performance, CPIF and AF, Block Development, Shared responsibilities, Incentives tied to acquisition outcomes**
- ▶ **Future – More oversight, harsher consequences for “failure,” Warning of becoming “too close”**



INCENTIVE REFORM

- ▶ **GAO Report, Defense Acquisitions, Dec 2005**
 - Recommended reform of current incentive practices
 - Recommended fee tied to acquisition outcomes
- ▶ **USD (AT&L) and SAF Policy Letters, Mar-Apr 2006**
 - Linked fees to performance outcomes
 - Rollover to be used only on an exception basis
- ▶ **SMC/CC Letter dated 15 Aug 2006**
 - Implemented GAO recommendations, and USD(AT&L) and SAF policies
- ▶ **DPAP Policy dated 24 Apr 2007**
- ▶ **SAF/AQ Policy 15 Jun 2007**
- ▶ **SMC/CC Policy dated Dec 2008**
- ▶ **New Report commissioned by Congress in 2008**
to Review impact of DoD policy changes
- ▶ **Visit from GAO – preliminary indications are that they believe that SMC is on board with new policy**





INCENTIVE REFORM

► SMC/CC 2006 Incentive Policy Letter:

- **Highly encouraged use of CPIF contracts, with potential award fee**
- **Mandated that performance, schedule, and cost incentives & their order of importance to the program to be discussed in acquisition strategy plans**
- **Encouraged Award Fee plans to link fees to mission success, achievements, deliverables, and objective results**
- **Chartered SMC/PK to develop an SMC Incentive Guide to provide guidance in implementing SMC/CC policy**



INCENTIVE REFORM

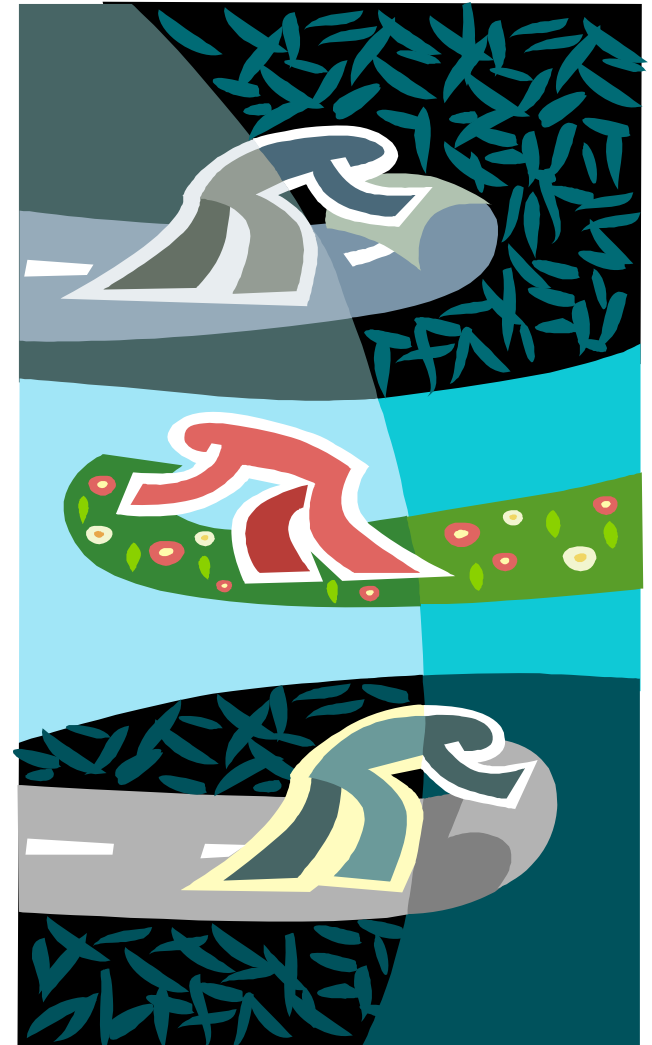
► SMC/CC 2006 Incentive Policy Letter (cont.):

- **Encouraged consideration of full range of incentive Kt types & features**
- **Emphasized use of hybrids that address cost, schedule & performance**
- **Discouraged overly complex incentive arrangements**
- **Encouraged collaboration with industry**
- **Noted that CPAF contracts, with subjective award fee criteria no longer
were the preferred incentive approach**



WAY AHEAD? - GET “BACK TO BASICS”

- ▶ **Emphasize deliberate risk apportionment**
- ▶ **Utilize four-staged acquisition approach**
- ▶ **Develop rhythm of research, design, build**
- ▶ **Improve collaboration on requirements**
- ▶ **Cost at and fund to 80% confidence**
- ▶ **Emphasize Systems Engineering and Integration**





CURRENT INITIATIVES

- ▶ **Cost incentives relate profit or fee directly to results achieved by Ktr**
- ▶ **Are normally based on a share formula**
 - **(i.e., fixed-price incentive (FPI) or cost plus incentive fee (CPIF) contracts) or the payment of a fee from an award fee pool**
- ▶ **To be effective they must be:**
 - **Quantitative**
 - **Clearly related to the desired outcome**
 - **Achievable**
- ▶ **Must offer rewards commensurate with risks the contractor assumes**
- ▶ **Cost to the Government must not be overemphasized or underemphasized relative to other program objectives**



CURRENT INITIATIVES

- ▶ **Cash flow is important to contractors in any incentive plan –**
- ▶ **Some arrangements that aid cash flow are:**
 - **Provisional payments for award fee**
 - **Award fee with a base fee**
 - **Performance-based payments for FFP contracts**
 - ▶ **Allow Ktrs to get paid upon completion of specific events**





CURRENT INITIATIVES



► Performance Incentives

- **Are designed to relate profit to the contractor's achieved results**
- **Based on specified targets: Quantifiable/Achievable/Easily Administered**
- **Should be used when they will induce better quality performance**
- **May be positive, negative, or a combination of both**
- **Performance-based SOW's are mandatory for Service Contracts**



CURRENT INITIATIVES

► Performance Incentives

- **Should be applied selectively to motivate efforts that may not otherwise be emphasized & to discourage inefficiency**
- **Incentives should apply to the most important aspects of the work, rather than to each individual task**
- **Limit number of incentives, otherwise**
 - **Dilutes the monetary importance of each requirement**
 - **Creates an administrative burden for the government focus on core, critical outcome-based expectations**





CURRENT INITIATIVES

- ▶ **Schedule Incentives focus on getting a contractor to meet or exceed **minimum** delivery requirements**
 - They can be defined in terms of:
 - ▶ Attaining or exceeding milestones
 - ▶ On-time criticality
 - ▶ Meeting rapid-response or urgent requirements
- ▶ **Reward to the contractor for accepting schedule risks must be consistent with the level of risk it assumes**





CURRENT INITIATIVES

► **Award-Term Contracts**

- **Award-term contracts reward exceptional contractor performance by extending**

the period of the contract for a prescribed period of time

- **Must comply with the *Competition in Contracting Act (CICA)***



- **To comply with *CICA*, ensure the maximum potential term and price/cost for that effort**

was part of the competition or the J& A Documentation



QUESTION

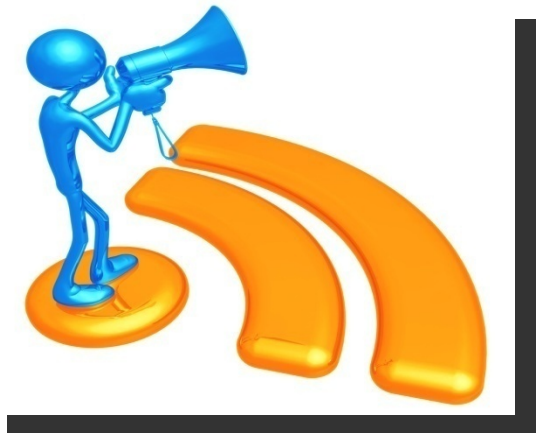
Is competition always a positive incentive?





INCENTIVES TODAY

- ▶ **Senior DoD Leadership is averse to award and fixed fee contract types**
 - Proper justification will ensure use of these types can be approved
- ▶ **New SMC contracts/restructures are using more objective incentives**
 - GPS III, NPOESS, WGS, SBIRS
- ▶ **Payback provisions have become popular**
 - Pro's vs. Con's
- ▶ **Senior leadership is encouraging “inclusive” approach to incentives**
 - Multiple incentives
 - DCMA participation recommended





INDUSTRY FEEDBACK

- ▶ **Wants base fee and provisional payments of award and incentive fees**
- ▶ **Disagrees with no fee for mission failure (high risk business)**
 - **Competing for capital with other business sectors**
 - **Wants proportionate fee for partial successes**
- ▶ **Rollover seen as effective tool**
- ▶ **Takes exception to withholding of cost**
- ▶ **Wants higher award fee pool in light of objective criteria**
- ▶ **Wants negative incentives offset with positive or higher pools**





SUMMARY

- ▶ Incentives should be designed so that the contractor earns the negotiated profit/fee if it meets the contract requirements
 - Exceeding the minimum contract requirements should result in more profit/fee
 - Not meeting Kt requirements should result in less than the negotiated profit/fee
- ▶ Incentives in the pre-delivery phase should motivate the contractor to achieve performance requirements, schedule, and cost in that order
- ▶ In post-delivery phase, remedies should be sought for missing Kt targets
 - Positive incentives should be provided for exceeding contract targets
- ▶ An incentive plan should be created that explains:
 - The nexus between the cost, schedule, and performance incentives, and
 - The allocation of the negotiated fee/profit to each area



SUMMARY

- ▶ **Correlate incentives to desired program results**
- ▶ **Use single or, when appropriate, multiple incentives**
- ▶ **Make incentives challenging, but achievable**
- ▶ **Recognize contractor motivations as well as Government needs**
- ▶ **Establish milestones associated with subcontract performance if critical**
- ▶ **Ensure to not overburden the Government and Ktr with administration**
- ▶ **Consult with legal on funding of incentives – must be enforceable**
- ▶ **Remember the stage of the acquisition when establishing incentives**





The Way Ahead

► **WHERE ARE WE HEADED?**

- **More Oversight – DCAA, GAO, IG, Auditors**
- **FIXED-PRICE CONTRACTS**
 - **Development & Production**
- **Harsher Penalties for Failure (Schedule & Cost)**
- **Less Team Orientation – Possibly More Adversarial**
 - **DCAA paradigm**
 - **IPT Pricing (Alpha contracting, Shoulder-to-shoulder)**
- **More Competition**
- **More Help from our friends in Congress**
 - **Regulatory and Statutory**
- **Back to the 80's?**



QUESTIONS?

